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2018

Online at <https://mpra.ub.uni-muenchen.de/98571/>

MPRA Paper No. 98571, posted 31 Mar 2021 11:31 UTC

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## Governance and banking system morphology in China: the evolution over the last two decades (1995–2015)

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**Abstract:** Over the past two decades in the Chinese banking system substantial progress has been made, and reforms have been mainly aimed at improving its governance and efficiency, but many governance problems still exist and hinder a complete transition to a market economy. Through the analysis of the economic freedom and the global governance indicators, in the context of a comparative analysis with European and North American countries, this paper shows that, despite a considerable economic growth, economic and financial reforms, Chinese governance variables are likely to have a second order effect in comparison with fundamental economic variables in favouring (or not) Chinese growth. However the high rate of growth, over the years of the financial turmoil as well, may have paradoxically prevented the improvement of governance indexes, meanwhile financial sector and global governance issues will have to be improved in order to promote efficient financial intermediation and sustainable growth in China.

**Keywords:** China; banking system morphology; governance indexes; economic growth.

**Reference** to this paper should be made as follows: Bellavite Pellegrini, C., Pellegrini, L. and Sergi, B.S. (2018) 'Governance and banking system morphology in China: the evolution over the last two decades (1995–2015)', *World Review of Entrepreneurship, Management and Sustainable Development*, Vol. 14, No. 5, pp.549–580.

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## 1 Introduction

Since its constitution in 1949, People's Republic of China (PRC) was featured by a planned economic system without private enterprises. No relevant changes in this economic policy occurred until 1978, when the deep economic reforms promoted by Deng Xiao Ping readdressed Chinese economy toward a more market-oriented system, which fostered high growth rates of gross domestic product (Green, 2003; Yueh, 2003; Italian Trade Commission Beijing Office, 2005). This new approach reflected the need to reform the state-planned economy and to build up a legal system capable of supporting economic growth and "restore for the regime the monopoly on legitimate coercion that had been lost during the Cultural Revolution" (Potter, 2004; Lubman, 1999). These reforms concerned areas like as crime and public security, contracts, taxation and foreign business. Moreover, income tax and other programs were introduced in order to encourage small business economy (Dana, 1999). This path was pursued progressively in the aftermath of the fourth constitution of PRC dating back to 1982, when Chinese economy was firstly defined as a 'socialist market economy' featured by and increasing degree of liberalisation and of competition (Hughes, 2002; Nathan and Gilley, 2003; Nolan, 2004; Tan, 2005; Tenev, 2006; Shi and Dana, 2013). This period of transition, known by the literature as the time 'from Mao to market' (Gittings, 2006), boosted the birth of business activity promoted by private entrepreneurs and compelled Chinese Government to update its legislation and the overall institutional framework in order to foster the economic growth (Fan, 2003; Dana, 2002).

In this way, a new powerful social class emerged. Particularly, managers of state-owned and collective enterprises, with valuable political connections, represented the largest group from which private entrepreneurs emerged. In the meantime, as reform proceeded and business has grown, the business governance of Chinese private enterprises partially evolved towards modern forms of systems, although many enterprises have not yet separated ownership from control (Chen et al., 2006).

Great steps forward had been implemented due to the program of reforms: China was successful in joining World Trade Organization in 2006 (Bank for International Settlements, 2003, 2005) and in March 2007 the Property Law was approved, allowing equal protection both to public and private sector and giving in this way 'par chances' to private entrepreneurs in developing economic activity (Atherton, 2008; Gov.cn, 2007a, 2007b).

Although the innovative legislation allowed private enterprises more operating freedom and flexibility than state-owned ones, the context of uncertainty over property rights and the risk of expropriation of the venture by the state partially still existed (Atherton, 2008; Lau et al., 1999), rendering, for some extent till nowadays, weak many governance issues, like the effectiveness of law enforcement (Lin, 1997; Potter, 2004; Peeremboom, 2002; Lubman, 1999), as we will describe in this article. China is still partially featured by a lack of contractual security and by ill-functioning information market (Krug and Hendrischke, 2002), factors which may generate 'structural and institutional holes' (Burt, 1992; Yang, 2004), affecting governance issues and economic development.

Therefore, generally characterised by weak financial structures, limited legal protection for property rights and high institutional uncertainty (Shi and Dana, 2013; Dana, 1999, 2002; Yang and Li, 2008) China's transition economy created however an environment in which entrepreneurship often develops in a different pattern form the more advanced economies (Shi and Dana, 2013; Ahlstorm and Bruton, 2002), highlighting partially "the enduring mystery of how China has managed to achieve impressive rates of economic growth over more than two decades (the eighties and the nineties) without an institutionalized system of property right" (Oi and Walder, 1999). Other economic literature investigates the issue of stability of the political and socioeconomic system to sustain growth (Chang, 2001), supporting the idea that "institutions play a rather different role in China than in the European and North American experience"<sup>1</sup> (Potter, 2004; Peeremboom, 2002; Lubman, 1999).

Although recent literature documented the existence of a relevant link between

corporate governance and firms' performance around the world, as an important factor in improving value and growth [i.e., Gill et al. (2014) for Canadian framework; Kyereboah-Coleman, 2007] particularly in Asian and developing countries (Rouf, 2011; Jackling and Juhl, 2009; Lusk et al., 2008; Saich and Jang, 2003), we document a lack in empirical studies focused on the relation between institutional governance at macro-level and growth of the single country. In relation with this evidence, we address our research to China in order to understand how did fit together the remarkable rate of economic growth and the evolution of institutional governance indices.

Different measures may therefore be considered in order to evaluate the degree of governance quality around the world. In this study, we take into analysis Chinese governance indexes since 1995 and till 2015, utilising the devices of the index of economic freedom, measured by the Wall Street Journal and Heritage Foundation for 186 economies in the world and by the Worldwide Governance Indicators, developed by the World Bank for 215 countries. We propose a comparative perspective with Western Europe and North American countries. Each indicator respectively measures different aspects of governance on the economic and financial environment over which government is supposed to exercise typically a properly conceived control. Furthermore, we highlight some short institutional evidences about nature and morphology of the Chinese banking system, because we believe that such deepened on its peculiarity may contribute to foster the outstanding of Chinese economic growth.

Despite the deep transformation of Chinese economy, countries governance indexes give evidence of a low level of transparency, disclosure, accuracy in accounting standards and of a not negligible level of corruption<sup>2</sup>, potentially jeopardising economic growth sustainability. Moreover, state-controlled companies are featured by poor corporate governance in terms of lack of transparency, weak internal control and protection for minority shareholders.

Meanwhile, improved governance may be beneficial in the long run in fostering economic growth and in attracting foreign capital from abroad, the empirical evidence suggests that till nowadays governance indexes have been mainly second best ingredients in fostering the high rate of growth of Chinese economy (Boyreau-Debray, 2003; Boyreau-Debray and Wei, 2004). This outcome is confirmed by existing literature devoted to East Asia (Arnone et al., 2006; OECD, 2003, 2005a), to European countries (Bellavite Pellegrini et al., 2011) and in more general terms to fast emerging markets (Bellavite Pellegrini et al., 2015; My and Truong, 2011). This paper is organised as follows: Section 2 provide institutional evidences on Chinese banking system; Sections 3 and 4 highlight some evidences about the reason for which governance indexes have been assuming an increasing relevance in institutional and financial debate giving evidence of the work in progress in corporate and banking governance; Section 5 overviews Chinese overall index of economic freedom evolution since 1995 to 2015, meanwhile Section 6 analyses the evolution of the above mentioned indexes, specifically related to China and specific regional area. A conclusive section provides further perspective related to governance indexes issues.

## 2 Banking system morphology in China

Like its economic system, the banking sector in China has undergone multi-faceted transformations since the Open Door policy in 1978, when Chinese Government introduced gradual reforms regarding both the banking system and its economy, in order to improve capital allocation, its profitability and transparency, and reduce government participation. Despite these reforms, China's financial system is definitely a credit oriented system, dominated by banks that represent about 80% of the entire financial system, most of which are state-owned, with problems of NPLs and low capitalisation, where the government still plays a strong role in credit allocation and pricing of capital. Therefore, the banking system is still the primary channel of financial intermediation, and the role of other segments of the financial system is still limited. The main features of the different parts of the Chinese financial system are the following:

- 1 *The banking sector*: It represents the first financial intermediation channel and its structure has been modified since 1978 (Deutsche Bank, 2004; Garcia-Herrero and Santabarbara, 2004; Prasad, 2005). In particular, as regards banking reforms, the transformation process has begun since 1979 with the substitution of a single-bank financial system and the introduction of different banking institutions, a first step toward the modernisation of the Chinese financial system. Before 1979, the People's Bank of China (PBC) was the only bank and, therefore, in charge of a large number of issues. As other centrally planned economies in China banks had a limited role in promoting economic growth. Nowadays the importance of capital markets is growing fast. In particular, there are four types of banks in China:

- a wholly state-owned banks (WSOBs) – who includes state-owned commercial banks<sup>3</sup> (SOCBs) and policy banks<sup>4</sup>
- b commercial banks<sup>5</sup>
- c credit cooperatives<sup>6</sup>
- d foreign banks<sup>7</sup>.

Despite the reforms' programs, ownership diversification, and improvement in profitability, the Chinese banking system still presents many problems: improvements in corporate governance, accounting standards and the regulatory framework are essential to bring China's banking sector standards in line with international practises, in order to allow these institutions to price risk more accurately and introduce better risk management techniques, increase the efficiency and transparency of the system, ensure transparent and more efficient lending

practices, prevent managers and insiders from using information for their benefits, and ensure equitable treatment for shareholders.

- 2 *Non-bank financial institutions:* Despite their limited role in financial system, there are several types of non-bank financial institutions:
  - trust and investment companies<sup>8</sup> (TICs)
  - insurance companies<sup>9</sup>
  - asset management companies<sup>10</sup> (AMCs)
  - securities and leasing companies<sup>11</sup>.
- 3 *Stock and bond markets:* in China, as in other emerging South-East Asian countries, the financial system is credit oriented, so stock and bond markets have a limited role. Economic theory however suggests that a more active role would be useful in promoting transparency, spreading information and improving intermediation, pricing of credit risk and corporate governance.

### **3 Why do governance quality indexes matter?**

In the last decades, the topic of corporate governance has increased in importance: several recent studies highlight its main features (Tirole, 2006) and illustrate the importance of corporate governance to the company, its stakeholders and the wider business and finance community (Mallin, 2004; Rouf, 2011). Also, financial difficulties and corporate downturns over the years have shown that sound corporate governance is essential to promote stability and restore investors' confidence, and a decreased governance standard affects issues regarding transparency, control and accountability (Barth et al., 2006). The concept of governance is broadly discussed among policy makers and in the academic debate since a long time (Kaufmann et al., 2005). Economic literature has explored the link between institutional change and economic performance (Mattei, 1997; North, 1990) and the role played by legal institutions in socioeconomic and political change (Jayasurya, 1999; Pistor and Wellons, 1999).

Today's successful economies are not necessarily geographically large or richly blessed with natural resource. Many economies have managed to expand opportunity for their citizens by enhancing their economic dynamism. In general, the overarching objectives of economic policies must be to create an environment that provides the most opportunity for the widest range of activities that can lead to increased prosperity. From this point of view, sustaining such economic dynamism is achievable only when governments adopt economic policies that empower individuals and firms with more choices, encouraging greater entrepreneurship. Growing economic freedom is unequivocally about more than financial success. Achieving greater overall prosperity that goes beyond materialistic and monetary dimension of well-being is equally important. In some countries, government policies and actions concerning the environment have become more intrusive and economically distortionary. Such policies impose a huge direct cost on society, and they also retard economic growth – and all for uncertain environmental benefits.

In particular, Levine (2004), dealing with banking governance, shows that weak governance has a negative impact on the economy, especially for economic development. In addition, given the greater opaqueness of banks than other firms and their greater

government regulation, this paper underlines the importance of strengthening the ability for private investors to introduce improved governance practices over banks than relying excessively on government regulators. In the Chinese banking system, the primary channel of financial intermediation, substantial progress has been made, and reforms have been mainly aimed at improving its governance and efficiency, but many governance problems in the financial sector still exist: the banking system is still mostly state-owned with problems of non-performing loans (NPLs), limited bank capitalisation and inefficient resources allocation. However, financial sector and global governance issues will have to be improved in order to promote efficient financial intermediation and resources allocation, ensure macroeconomic stability, and sustainable growth.

Several authors have given a valid contribution to this subject (García-Herrero and Santabarbara, 2004; García-Herrero et al., 2005), showing that banking in China represents a fragile component of its economy with its poor lending policies that have favoured the rise of NPLs. After describing the banking market and identifying challenges facing the banking industry and recent policy responses (such as the measures introduced by the banking supervisory authorities), these studies underline that Chinese banking sector has the potential to stimulate sustainable growth.

#### **4 Corporate and banking governance: work in progress**

Over the years, China has made significant progress in developing corporate and banking governance, and in defining the role of the state: different banks and enterprises have modified their ownership structure, also through the public listing, favouring the entry of foreign capital and private investors and decreasing political interference. Moreover, new regulatory bodies, independent directors system and corporate governance codes have been introduced. However, real and financial sector restructuring has been quite slow, despite the reforms' programs. For emerging countries such as China, improving their economic system and strengthening their institutions are essential requirements, if they want to promote long-term growth that allows them to face challenges and shocks. In particular, the Chinese banking sector still presents many limits: the solvency of Chinese banks is still weak and their profitability is poor; moreover, because of the political influence, there are high levels of NPLs and assets quality is low. Management systems are often inefficient and lack adequate management skills; despite the establishment of new regulatory bodies and the introduction of corporate governance codes, internal controls are still weak and problems regarding an unclear division of responsibilities among supervisory bodies still exist. Dominant banking institutions remain four large state-owned banks, with problems of NPLs, lack of transparency, corruption and other abuses. Therefore, China's transition to a market economy is incomplete. The state continues to maintain a dominant role in banking sector and in the companies ownership. There are also problems of inefficient capital allocation and NPLs for banks, as well as poor governance, weak internal controls, and lack of adequate risk management systems.

For Chinese SOCBs and commercial banks as a whole, the objectives of the reforms aim to raise asset quality and solvency, and favour their transformation in more financially sound and independent commercial institutions. For instance, it is essential to redefine the role of the state, eliminate or decrease the negative impact of dominant state ownership on market discipline and improve state role as supervisor and regulator.

Ownership diversification is important in order to decrease conflicts of interest where local governments influence lending decisions when they are both the owner and regulator (World Bank, 1997, 2006). Privatisation can be a solution, in order to decrease NPLs and favour a more commercially-oriented lending activity of these banks. Furthermore, the entry of foreign capital is useful to stimulate competition and improve quality of services: foreign ownership can promote the transfer of technical knowledge, the introduction of more efficient risk assessment and management systems, new and innovative skills, better corporate governance, and the improvement of the quality of the human resources. Another important step concerns the strengthening of the role of the Board of Directors (OECD, 2003), particularly regarding the appointment of the top management of a bank. The relevance of the role and of the composition of the board of director has been clearly emphasised by many corporate governance studies: the independent directors' role is important to promote more transparency. Specifically, large banks should have an internal credit-risk rating system based on Basel II, while smaller banks should try to apply elements of best practices for managing credit risk by collecting data about borrowers (Ping, 2003; CBRC, 2005). In this transition context, for Chinese banks, it is important that boards monitor with particular care larger exposures, and control lending activities and general risk exposure more frequently, in order to avoid crisis, and it is also essential a clear division of responsibilities among banking bodies regarding risk management.

Chinese banks also have to strengthen credit controls, in order to improve their governance, and appoint a Chief Credit Officer (CCO), because one of the major risks that banks are facing is credit risk, where a strong credit management function needs to be independent from the business operating units. As regards supervision, in addition to improving cooperation between different supervisory bodies and promoting a clearer division of responsibilities, all banks need to have an independent internal audit function, that it must be independent of operations of the bank so that it can act as a 'check and balance' against weaknesses or breaches of procedures within the organisation. Another fundamental step in promoting good governance is the public listing, where admission to the listing is a signal that the bank meets the listing standards at the time of the IPO, and subsequently through market monitoring after the bank is listed. Also, through the listing banks should favour the entrance of strategic investors, including foreign investors, in order to benefit not only from their capital injections, but also from their technical assistance in different areas and their position on the boards, in order to push for governance reforms. Moreover, it is important to promote cooperation among financial institutions in China for better governance, in order to combine resources and gain synergies to compete against foreign players. Also, the convergence with international standards for accounting, audit and transparency can improve the level of corporate governance. In conclusion, substantial progress has been made in banking reforms to improve governance, but considerable works remains to be done, in order to increase the efficiency of banking intermediation.

## **5 Index of economic freedom – the overall score: empirical evidence in a comparative perspective**

Taking into account the years since 1995 to 2015, we highlighted different trends of governance evolution in the various areas. If we look at the world average score of the



index, we may assert that world economy looks like to be ‘moderately free’. The score for 2015 is 63.4 that represent a 7.03% overall improvement since the 1995, with significant different among regional areas: ranging from a minimum value of -2.37% registered for Latin America and a maximum value of +23.7% for transition countries. Regarding the general score about economic freedom in the first decade we notice a significant improvement in Western Europe (+7.9%), North America (+6.57%), Transition economies (around +14%), Sub-Saharan Africa (+6.71%) and in the Caribbean (around +14%), meanwhile the Middle East and North Africa region registers a significant decrease (-4.27%). Between 2005 and 2015, the overall index of economic freedom remains stable in Western Europe and North America, while the scores of some regional area improved (i.e., transition economies, Asia and Pacific and Middle East and North Africa), and for others worsened (i.e., Latin America and Caribbean). During this last decade, economic and financial turmoil looks like to have realised different impacts in regional areas. North America and Western Europe continue to be the world’s most economically free regions, but transition economies, Asia and Pacific and Middle East and North Africa show some improvements. Despite meaningful improvements, the number of people living without economic freedom remains extremely high (about 65% of the world’s population) and are concentrated in two countries: China and India. In these two countries, advancements toward a higher degree of economic freedom are still limited. Some structural reforms in a few key sectors have sometimes driven the growth, but the government failures in the institutionalisation of an open environment to promote broad-based and improvements for freedom are still strong.

The average score for countries belonging to the sample shows a slight increasing over the 20 years. This evidence may be associated with increasing values of the indexes of ‘fiscal freedom’, ‘monetary freedom’ and ‘trade freedom’.

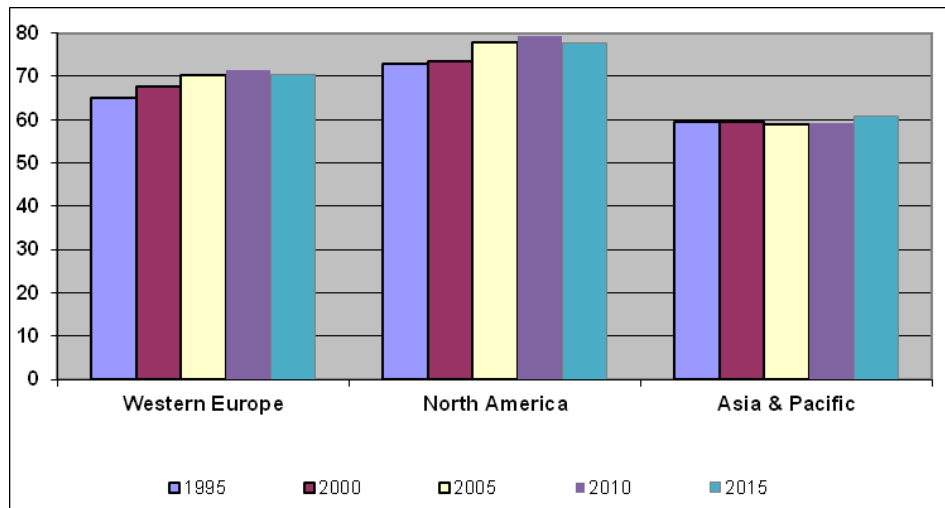
Western Europe region includes 19 countries: two ‘free’ economy (Ireland and Switzerland) and some of the freest countries in Europe. The average overall scores increases of 8% during the two decades. Altogether, however, the region still struggles with some policy barriers to dynamic economic expansion, higher tax burdens, costly labour regulations and increasing difficulties in public finance management.

North America region shows two ‘mostly free’ economies (Canada and the USA). The average overall score for the whole period of analysis registers an increase, mainly driven by market openness indicators. Free Trade Agreement remains the key indicator of massive trade and investment flows (14% and 25%).

Coming to Asia-Pacific area, during 2015 Philippines, Malaysia and Taiwan significantly contributed to the improvement of the overall score. Nevertheless, Asia-Pacific area, whose countries are mainly ranked as ‘mostly unfree’, juxtaposed four of the freest economies in the world (Hong Kong, Singapore, New Zealand and Australia) and the most repressed (Burma and North Korea, i.e.). In this context, India and China are ranked at the lowest scores in the ranking during the time of observation registering during the 2015 the 128th and 130th position, respectively, in the world. Despite these divergences, the region looks like to show economic resilience and dynamism. The high level of trade freedom (+43.8% during the period of analysis) point out that economies of this area have been capitalising on the freer flow of good and services, amplifying economic development and facilitating the development of trade agreements. Among the regions, average level of the index differs widely (see

Appendix 1). The diversity of the world's people and culture implied different paths to economic development and prosperity.

**Figure 1** Index of economic freedom\*: overall score by regional areas\*\* (see online version for colours)



Notes: \*A decrease of the index of economic freedom measures a worsening of economic freedom conditions and the other way around.

\*\*Countries and areas are ranked as follows: *Western Europe*: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Malta, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the UK. *North America*: Canada, the USA. *Asia and Pacific*: Australia, Bangladesh, Burma (Myanmar), Cambodia, China (People's Republic of), Fiji, Hong Kong, India, Indonesia, Japan, Korea Democratic Republic of (North Korea), Laos, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Papua New Guinea, Philippines (The), Singapore, Sri Lanka, Taiwan, Thailand, Vietnam).

Source: Heritage Foundation website; our elaboration

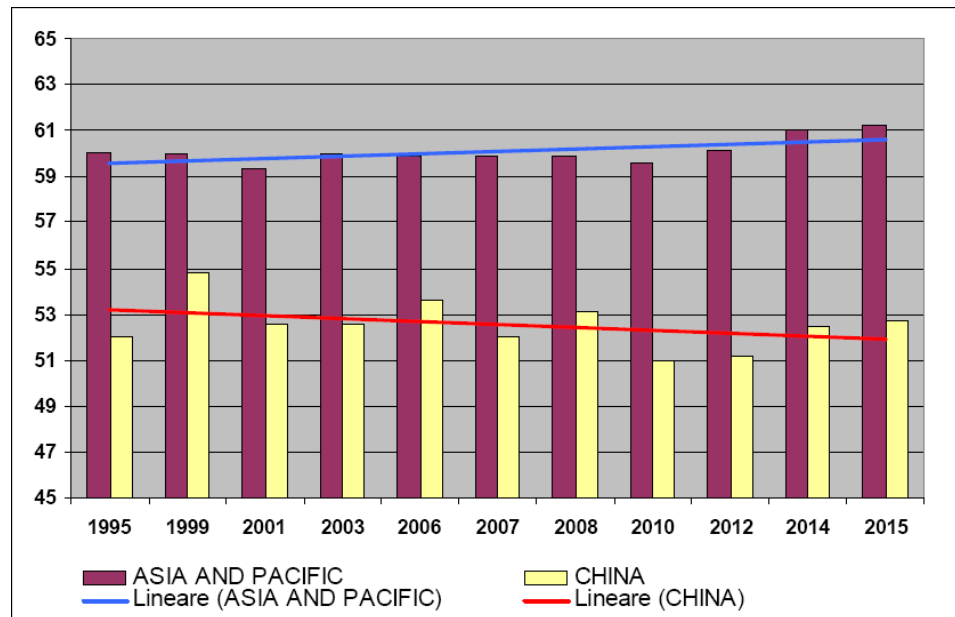
## 6 Chinese governance indexes vs. Western Europe and North American countries

If we take into analysis more specifically Asia-Pacific countries, this index on average shows a light increase since 1995, although the index related to China remained substantially unchanged with slight decline in the overall score, quite close to the lower boundary of the 'mostly unfree' category.

In relation with the general score, China moved from 52.7 in 1995 to 56.4 in 2000, successively dropping down to the same value registered during the first years of analysis. This poor performance about economic freedom is however consistent with an outstanding rate of economic growth (OECD, 2002, 2005b). Chinese Government and

International Monetary Fund report that since 2007 gross domestic product increased yearly of roughly 10%. Moreover China emerges as the world's third largest trading nation in 2005, (World Bank, 2005, 2006) becoming the second in 2009 and finally surpassing the USA as world's largest trading nation in 2013.

**Figure 2** Index of economic freedom – overall score: Asia and Pacific vs. China (see online version for colours)



Source: Heritage Foundation website, our elaboration

China's index of economic freedom ranked respectively 130th in 2015 and 129th in 2014 and it is lower than the global and regional averages. If we look at the global trend of the whole period of time, it reveals a complex framework: after a consistent increase during the first years, since 2000 the economic freedom in China has undergone a relevant decrease, probably connected with the emphasis of the five year economic plan. Moreover, we remark neglectable improvements for some of the ingredients on the one hand, and decline for some others on the other hand. These evidences are linked with the specific role in China of the Communist party which holds influence both on the judicial system and economic activities, triggering a potential corruptive context (Prasad, 2005; World Bank, 2006).

In relation to market openness indicators, trade freedom has slightly improved during the whole period of time, while scores for investment freedom, financial freedom, property rights, and the control of government spending have all suffered double-digit declines. Although the boost in trade freedom has undoubtedly helped to support China's overall growth rates, the deterioration in other categories indicates that economic reforms may be desirable in order to frame a more balanced and sustainable perspective for Chinese business and economic activity.

During the first years of analysis, it may observe that trade is dominated by intra-industry trade in manufactured goods. Despite the evidence of a growth trend, data of the first decade underline the persistent impression that significant barriers still exist to the movement of factors of production, and to trade in services and intermediate goods (Naughton, 2000). Afterwards, the significant increase of trade freedom, connected with the Chinese joining to World Trade Organization in 2006, has been supported by the decrease in tariff trade, counterbalanced by the introduction of export taxes, subsidies to state-owned enterprises, anti-dumping barriers and tariffs (International Monetary Fund, 2005).

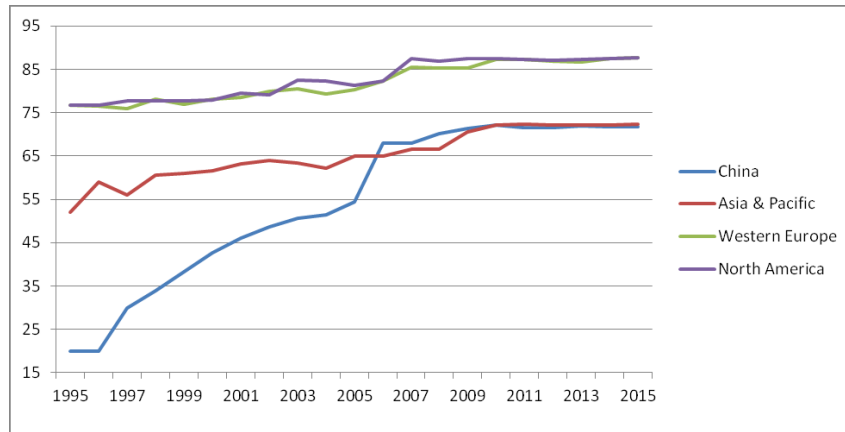
In relation to the indexes of investment freedom and financial freedom, the decrease of these two latter may be affected by government's control on foreign investment, the conditions of access to credit and the strictly connected lack of transparency. The discipline of market principles that could enhance efficiency and long-term competitiveness has become sporadic and it is unequally distributed throughout the country. These evidences are connected with the absence of political willingness to undertake more fundamental restructuring of the domestic economy, probably because the high rate of growth experienced over the past years by China has anesthetised the quest for governance improvement. On the other hand, we have to recall that the main focus of the tenth five year economic plan (2001 to 2005) was mainly devoted to a 'going out strategy' connected with a significant flows of Chinese direct investment abroad (Prasad and Wei, 2005).

If we take into analysis more specifically the banking score of the 'financial freedom' index dropped from 50 in 1999 to 30 in 2015. China's banking system remains almost entirely state-owned (four state-owned banks hold over 50% of total banking assets), either directly or through state-owned companies. However, the restructuring of the real and financial sectors and the liberalisation of the financial system have proceeded relatively slowly notwithstanding the reform efforts, hypothetically because of the combined nature of second best of the governance indexes and of the exceptional rate of growth of Chinese economy over the analysed period (Tang, 2004; Taylor, 2006).

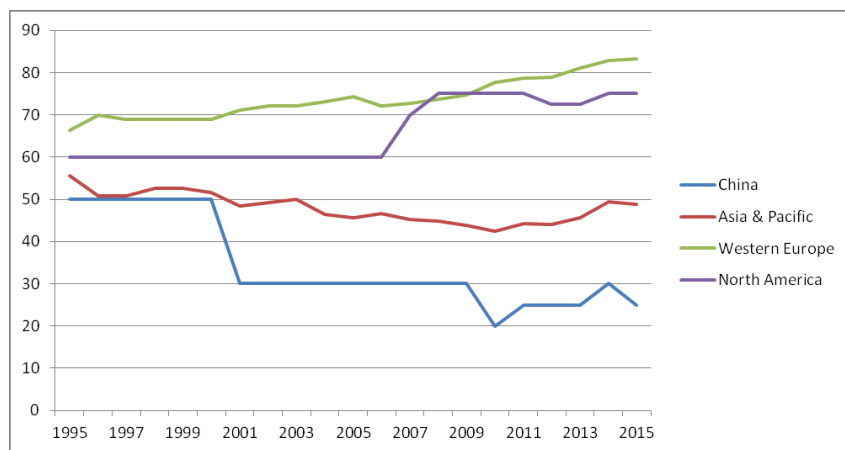
North America and Western Europe move together for all the three scores, better than Asia and Pacific area and even more than China, registering an improving trend. Observing Figure 3, we highlight that, with the exception of trade freedom index, China register negative slope during the two decades, according to Asian and Pacific countries but with a more accentuated trend. Considering Asia and Pacific region, we found Hong Kong as one of the most open economies in the world for international and trade investment, together with its financial sector who remains highly competitive and well capitalised. On the contrary, we register India, Indonesia, Japan and the Philippine as countries characterised by various non-tariff-barriers that impede the free flow of good and services and distort trade, together with capped foreign investment.

Western Europe trade agreement is currently being negotiated with countries that include the USA and Japan. In Germany, Austria, Belgium and Luxembourg, the financial sector appears competitive and stable, offering a full range of services, while in countries like Italy, France and Spain the financial system's overall stability has been undermined and remain fragile.

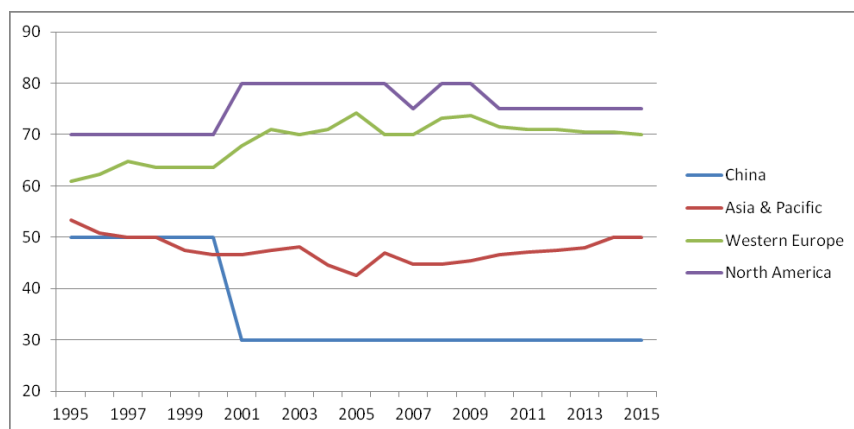
**Figure 3** Market openness indicators (1995–2015), (a) trade freedom (b) investment freedom (c) financial freedom (see online version for colours)



(a)



(b)

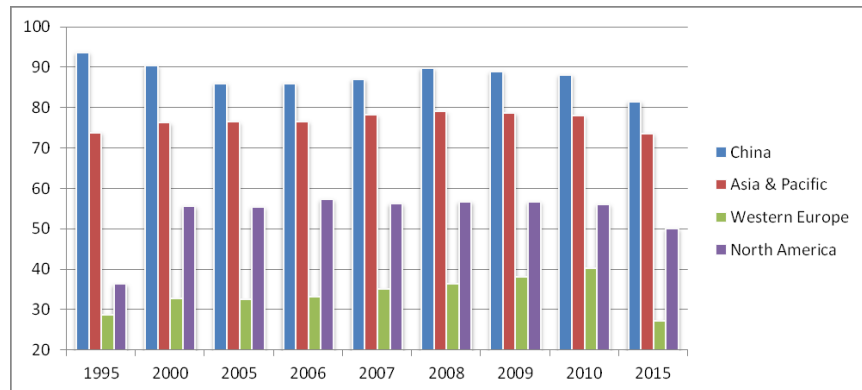


(c)

**Figure 4** Government size (1995–2015), (a) fiscal freedom (b) government spending (see online version for colours)



(a)



(b)

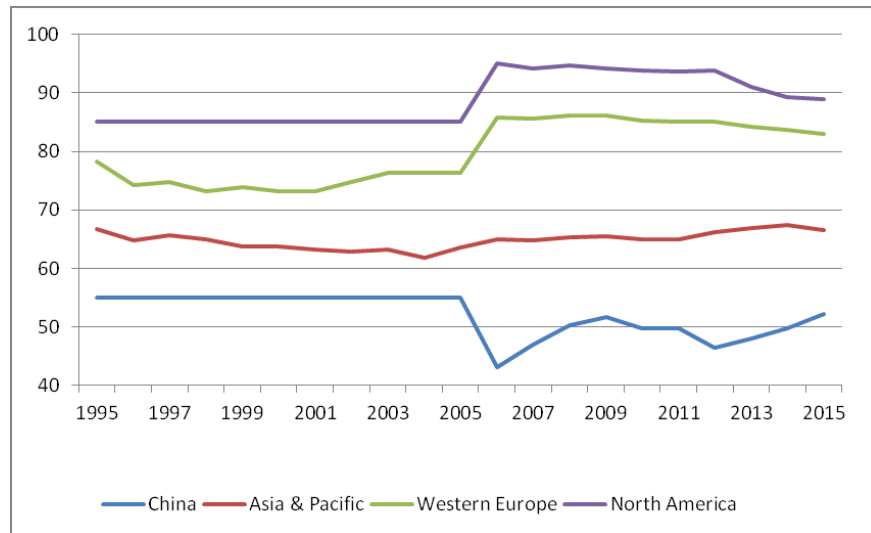
Source: Heritage Foundation website, our elaboration

Considering government spending as economic governance variable regarding government's intervention in Chinese economy, during 1995, the country was characterised by a very high level of state intervention (93.70), through both consumption of scarce resources and involvement in business activities that may be eventually carried out more efficiently in the private sector. The Chinese indexes show on average a better trend in comparison with Western Europe (for both indexes) and with North American countries (for government spending index only).

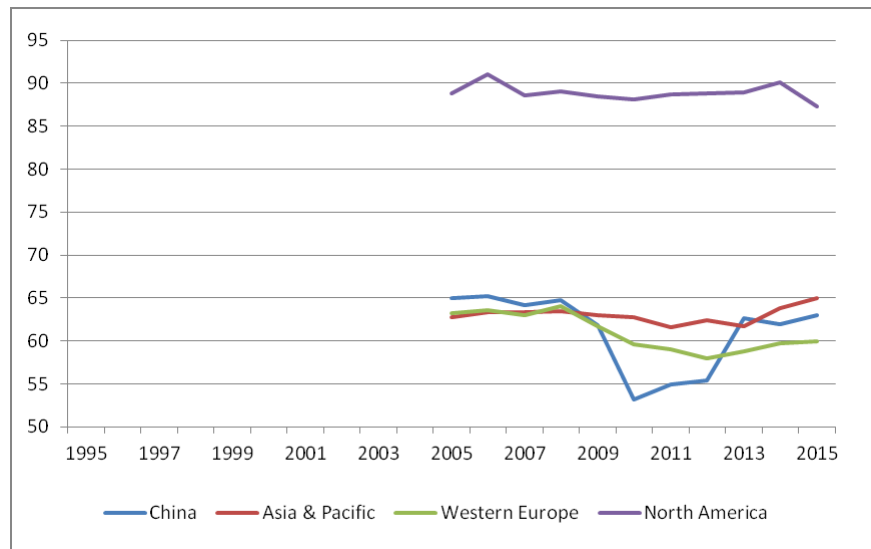
During 2006, the value decreased to 86 marginally increasing till 2008 and then decreasing for the rest of the period. The final year 2015 registers a value of 81.5 with a

government expenditures that account for 24.8% of the domestic output (23% in 2012), public debt equals to 22% of GDP (33.8% in 2012) and the tax burden equal to 19.4% of GDP (17.5% in 2012).

**Figure 5** Regulatory efficiency (1995–2015), (a) business freedom (b) labour freedom (c) monetary freedom (see online version for colours)



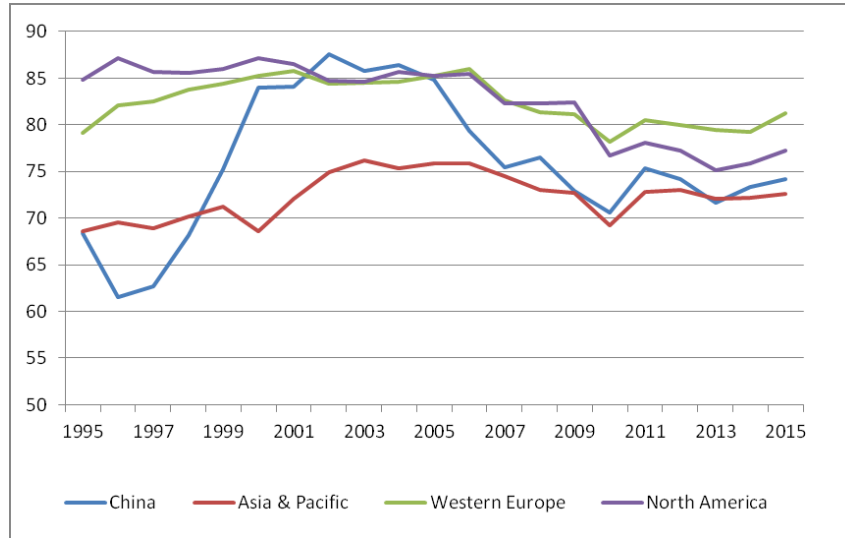
(a)



(b)

Source: Heritage Foundation website, our elaboration

**Figure 5** Regulatory efficiency (1995–2015), (a) business freedom (b) labour freedom (c) monetary freedom (continued) (see online version for colours)



(c)

Source: Heritage Foundation website, our elaboration

Some comparative evidences of these indexes related to other European or North American countries may contribute to improve the comprehension of the Chinese peculiarities (see Appendix 1). To whom it concerns European countries, the more recent overall tax burden goes from 27.1% of GDP for Switzerland to 45% of GDP for France (36.7% Germany; 32.6% Spain; 42.6% Italy; 43.8% Belgium, among the others), together with a government expenditure that account in range between the 33.5% of total domestic output for Switzerland and the 57.5% for France (the other main countries are around 50%). The public debt value gains critical condition in European countries: except for Sweden and Luxembourg (one-third and 25% of the total domestic output) in all the other countries the public debt levels are alarming, being in the 4th quartile of the distribution and even more (i.e., Italy exceed 130% of the GDP). North American countries show a different situation: the USA registers an overall tax burden equals to 25.4% of GDP and government spending about 39% of the total domestic products, while Canada shows tax burden equal to 30.6% and government spending amount to 40.7% of GDP.

If we take into consideration China's legal and regulatory system, business freedom score remains very low: a level of 55 is registered during all the first decade of observation, suffering a consistent decline in 2006. Notwithstanding, a smooth recovery since 2006, the final score in 2015 is still below the level in 1995. A similar trend may be detected observing labour freedom, experiencing a lower point in 2010 and a recovery in the following years, being again the final point of our historical series still below the starting point in 2005. Some of these improvements featuring the final years of our historical series may be connected with the launch of the 12th five year economic plan (2011 to 2015) addressed to organise a more market oriented institutional environments, fighting the heavy weight of a central planned economy's bureaucracy. Monetary policy

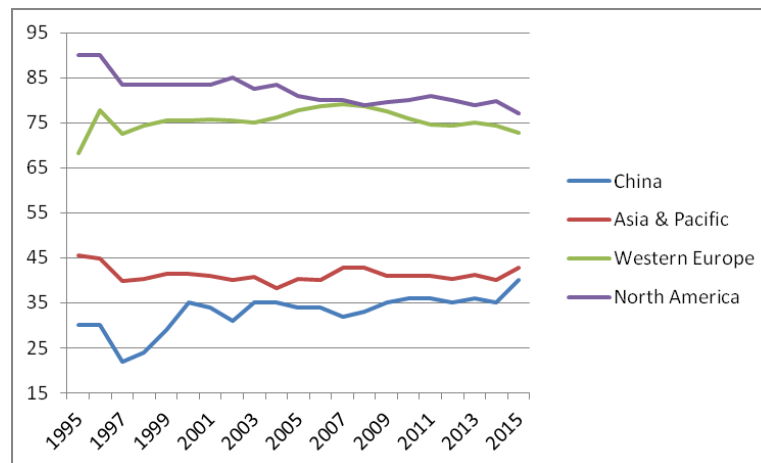


registers a clear improvement over the years till 2006 and experiencing again a significant decline since then till the end of the period.

**Figure 6** Rule of law (1995–2015), (a) property right (b) freedom from corruption (see online version for colours)



(a)



(b)

Source: Heritage Foundation website, our elaboration

The Asia and Pacific regions register more stable indexes although characterised by a suffering condition. Except for Hong Kong and Singapore, where the overall entrepreneurial environment remains one of the world's most transparent and efficient, the labour market is vibrant and the labour force participation rate has gradually increased since 2010, in the other countries organising new investment and production remains burdensome, full of regulatory rigidities and costly, and labour market is underdeveloped and characterised by strong inefficiency.

European countries show, on average, better indexes to whom it concerns business freedom and monetary freedom (Germany, Luxembourg, Belgium, Sweden and Switzerland better than the others), while we underline problems in the labour market (i.e., Italy, Portugal among the others), which appears fragile, stagnant and inflexible. These evidences could be view in Figure 5(b) that highlights the better position of labour freedom index for North American countries. The evidence are mainly driven by Canada that, with its highly competitive regulatory frameworks (truth for US also) promotes business formation and operation. Moreover, flexible labour regulations enhance employment and productivity growth.

Rule of law may be disentangled in two different indexes: property rights and freedom from corruption. The first registers a stable trend till 2006 and successively worsened significantly. The low level of the score in property rights may be explained because of the weakness of the judicial system, yet highly vulnerable to the multifaceted aspects of political influence and connections, featuring Chinese economy. The common and constant presence of infringements on copyrights, patents, and trademarks is a common feature for China, jointly with the absence of protection's measures for intellectual properties. Conversely, freedom from corruption index registers a slight increase overall the whole period and a more pronounced one since 2006, because of the recent commitments of the authorities to fight corruption since the Chinese joining to World Trade Organization, which was carefully planned in the years of the 11th five year economic plan (2006 to 2010). The issue of corruption is associated with the specific role of the Chinese state which juxtaposes the role of owner and regulator. This intertwined aspects may be considered as the effective Achilles's heel of Chinese economy.

The American people's trust in their government is the lowest it has been in the past ten years, according to the three Gallup polls released in 2015, with 75% of respondents saying they believe corruption is widespread in the government and in government regulation of business. Although property rights are guaranteed and the judiciary functions independently and predictably, protection of those rights in practice has been uneven. Canada has a reputation for clean government instead, a judicial system with an impeccable record of independence and transparency, and vigorous prosecution of corruption cases. Although 89% of Canada's land area is owned by the state, the 11% that is privately owned property is well protected. Moreover, enforcement of contracts is very secure.

The evidences related to 'freedom from corruption' index for Western European countries should be divided into different and opposite groups: on the one hand we point out countries like Belgium, Luxembourg, Sweden and Switzerland where corruption is relative rare or low and government had increased its prevention and prosecution effect against corruption. Moreover, the judiciary is independent, and social norms and customs strongly support the rule of law. On the other hand, we highlight France, Spain and Portugal where, although the government actively promotes transparency, accountability and civic participation, questionable political party influence and party donation still exist, together with lack of preventive measure for corruption in party funding and public procurement. Furthermore, Italy showed a series of high-level, politically destabilising corruption scandals, culminated in a December 2014 investigation of numerous Rome municipal officials implicated in a public contracts corruption case, known as 'Mafia Capitale' and the legal system is vulnerable to political interference. To whom it concerns property right index, we register a common positive condition: with the exception of

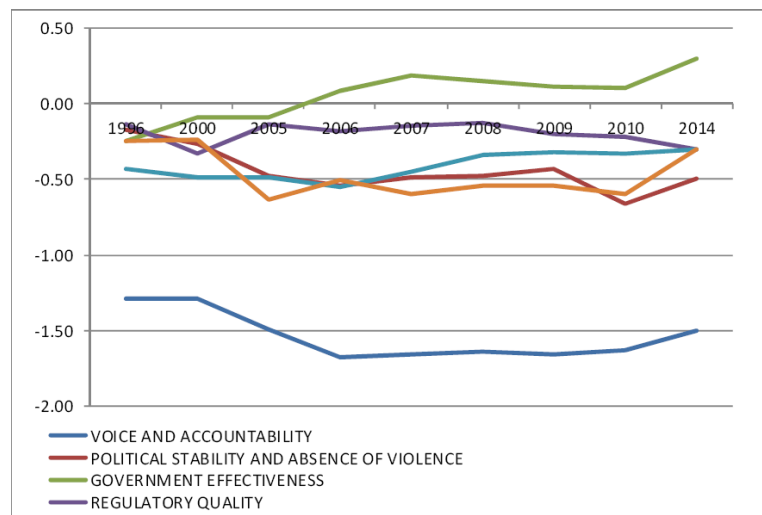
Greece, all the Western European countries well protect property right and the contracts are secure.

In order to give a more widespread comprehension of Chinese governance, we provide additional and complementary global governance indicators elaborated by the Wall Street Journal and World Bank. Because of the different period of availability of these data (1996 to 2014), we focus specifically our attention mainly on four not otherwise available indicators, i.e.:

- a voice and accountability
- b political stability and absence of violence
- c government effectiveness
- d regulatory quality.

The above mentioned indexes showed a slight, but continue worsening since 1996 till 2014, highlighting a decrease in governance quality, despite the magnitude of the rate of economic growth. More specifically, government effectiveness and regulatory quality register a decrease over the last five years, meanwhile the decrease of the political stability and absence of violence index dates back to 2000. In particular, over the past two decades, China's economic reforms have brought remarkable growth, thanks also to the progressive openness of the economy to outside since 1978. As we have just remarked such extraordinary economic performance does not fit with a clear improvements of governance indexes. On the contrary, all these indexes, quite poor in 1995 indeed, register a substantial decrease over the two decades. Political stability and absence of violence decreases from  $-0.2$  in 1996 to  $-0.5$  in 2014, as it is shown in Figure 7.

**Figure 7** Worldwide governance indicators (1996–2014) (see online version for colours)



Source: World Bank, *Worldwide Governance Indicators Database*, our elaboration

From this point of view, whenever the objective of the Chinese Government were the pursue of a harmonious society which distributes to the citizens the remarkable benefits of the extraordinary industrial development of the last two decades, this target was not achieved. We provide further evidence of this phenomenon observing the voice and accountability variable.

The score of this index, being negative in 1996 registers a further decrease from  $-1.3$  to  $-1.5$  in 2014 because of the protests of the population for their living conditions and the increasing inequality always more enveloping the country. Notwithstanding, these poor performances of these indexes, not uncommon in rapidly developing countries (Arnone et al., 2006), the index of government effectiveness realised a significant increase improving from  $-0.25$  in 1996 to a maximum of  $0.15$  in 2008, diminishing later on to roughly  $0$  in 2012 and up to  $0.3$  in 2014, as highlighted in Figure 7. Chinese Government policies have been partially successful in increasing domestic demand and reducing the development gap among different country's regions, improving agricultural productivity and implementing some sort of more system for health and welfare. Over time, these achievements have contributed to reduce Chinese poverty rate, with a positive impact on the world poverty reduction (Tseng and Cowen, 2005). Regulatory quality indicator shows overall a negative score, worsening however from  $-0.1$  in 1996 to  $-0.5$  in 2002, improving again to  $-0.1$  in 2008 and then worsening again till  $-0.3$  in 2014.

Meanwhile, the substantial increase between 2002 and 2006 may be ascribed to the requirements for joining the World Trade Organization, the successive diminution finds probably its roots in the low level of coordination among different Chinese authorities and the unclear division of their responsibilities and because inefficient and incomplete reforms are likely to affect negatively foreign investor perspectives.

## 7 Conclusions

After different financial scandals, financial crisis and the loss of investors' confidence in the market, the interest in corporate governance has grown considerably in the last decades. In China, corporate governance has been seen as an important element to accommodate the needs of changing business environment, given the transition to a market economy. The government is aware that if China wishes to attract more investors it will need to have a corporate governance system that protects minority rights, guarantees transparency and timely information, and favours confidence in corporate activities.

Despite the considerable Chinese economic growth, the overall governance overview remains quite poor, but it not likely to have negatively affected the remarkable economic performance over the last two decades. According to the above mentioned existing literature, we may assert that governance variables are likely to have a second order effect in stimulating and supporting economic growth, in comparison to other macroeconomic variables, but they have not prevented a rapid economic growth.

However, a more detailed analysis of the whole period shows that around 2006, the date of the Chinese joining to the World Trade Organization and the launch of the 11th five years economic plan, governance indexes registered a marginal increase. Chinese participation to the WTO contributed to the fostering of Chinese manufacturing production, exports and created an enormous market of commodities with competitive prices.

Over the years, this has turned China into a global economic force. The banking sector has been changed by reforms, because it represents a very important source of external financing for firms that most of the times do not have direct access to financial markets. Banks continue to dominate China's financial sector, where the four SOCBs are the driven force, but with problems of low transparency, lack of protection for investors, government interference and high level of NPLs.

Because of this external pressure, Chinese Government is likely to have attributed more importance to governance indexes and, in a more limited way, to corporate governance indicators as well. Meanwhile, governance indexes may have not therefore been the key ingredients of the past outstanding Chinese economic performance; it is likely that they may represent key factors in the future for attracting foreign capital inflows and creating condition for sustainability of Chinese economic growth. More specifically, the past poor performance of many governance indexes in China is strictly correlated with the relevant role played by the state in economy and in economic development. Moreover, marginal increase or decrease of such indexes may be explained by the specific focuses of five years economic plans which occurred in sequence during the mentioned period of time.

While on one hand an improvement of governance indexes in China is likely to be a mandatory path in order to support and improve future economic performances, these are strictly linked with the political willingness of a withdrawal of Chinese state from direct intervention in the economy and in assuming a regulatory role, according to the market oriented economy standard. In particular, Chinese Government should create a more market supportive legal and regulatory framework.

For China and other Asian emerging economies where banks generally play a more important role than in other financially-advanced economies, it is essential to have sound financial institutions and promote their modernisation in order to favour long-term growth and the transition to a market economy. The modernisation process must include different aspects, such as the regulatory system, corporate governance, ownership and property rights, financial infrastructure, accounting standards, payment and credit systems, risk management, and law enforcement: they are essential steps to enhance efficiency and governance. Important improvements need to be made in modernising internal systems for credit assessment, loan monitoring and risk management, introducing also new loans classification system and deposit insurance scheme, in order to favour a more accurate risk pricing and increase the efficiency of the system. The success of banks' restructuring and reforms is therefore an essential and necessary step for further financial reforms, which in turn would strengthen financial soundness and macroeconomic stability, and foster sustainable economic growth.

An agenda of future research may be devoted in declining these outcomes at corporate levels and eventually in other fast emerging economies, in order to verify to which extent governance indexes and corporate governance affect industrial and eventually financial corporation's stock returns.

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## Appendix 1

**Table 1** Trade openness, government size, regulatory efficiency, rule of law indexes, by regional area and by years of analysis-average values

Market openness indicators															
Regional area	Trade freedom			•%		Investment freedom			•%		Financial freedom			•%	
	1995	2005	2015	1995–2005	2005–2015	1995	2005	2015	1995–2005	2005–2015	1995	2005	2015	1995–2005	2005–2015
Western Europe	76.7	80.2	87.7	4.54%	9.28%	66.4	74.2	83.2	11.82%	12.06%	60.9	74.2	70.0	21.84%	-5.67%
North America	76.8	81.3	87.7	5.86%	7.87%	60.0	60.0	75.0	0.00%	25.00%	70.0	80.0	75.0	14.29%	-6.25%
Asia and Pacific	50.3	64.5	72.3	28.33%	12.08%	55.3	45.0	47.8	-18.57%	6.22%	53.2	42.1	49.2	-20.83%	16.91%
Government size															
Regional area	Fiscal freedom			•%		Government spending			•%						
	1995	2005	2015	1995–2005	2005–2015	1995	2005	2015	1995–2005	2005–2015					
Western Europe	52.2	54.9	57.5	5.07%	4.67%	28.7	32.5	27.2	13.3%	-16.3%					
North America	64.5	71.9	73.1	11.40%	1.67%	36.3	55.4	50.1	52.6%	-9.7%					
Asia and Pacific	62.0	73.5	76.5	18.59%	4.11%	74.9	76.8	73.9	2.6%	-3.8%					
Regulatory efficiency															
Regional area	Business freedom			•%		Labour freedom			•%		Monetary freedom			•%	
	1995	2005	2015	1995–2005	2005–2015	1995	2005	2015	1995–2005	2005–2015	1995	2005	2015	1995–2005	2005–2015
Western Europe	78.2	76.3	82.9	-2.39%	8.67%	-	63.2	60.0	-	-5.11%	79.17	85.28	81.19	7.72%	-4.80%
North America	85.0	85.0	88.9	0.00%	4.59%	-	88.8	87.3	-	-1.69%	84.85	85.20	77.25	0.41%	-9.33%
Asia and Pacific	66.1	63.1	65.9	-4.43%	4.46%	-	62.8	64.9	-	3.33%	68.58	76.28	72.71	11.22%	-4.67%
Rule of law															
Regional area	Property right			•%		Freedom from corruption			•%						
	1995	2005	2015	1995–2005	2005–2015	1995	2005	2015	1995–2005	2005–2015					
Western Europe	75.5	83.7	81.6	10.91%	-2.52%	68.2	77.8	72.7	14.09%	-6.50%					
North America	90.0	90.0	85.0	0.00%	-5.56%	90.0	81.0	77.0	-10.00%	-4.94%					
Asia and Pacific	61.6	45.8	43.2	-25.57%	-5.75%	44.7	40.1	42.7	-10.31%	6.30%					

Source: Heritage Foundation website, our elaboration

**Table 2** Fiscal freedom – by country (1995–2015)

<i>Fiscal freedom</i>	<i>1995</i>	<i>2000</i>	<i>2006</i>	<i>2010</i>	<i>2015</i>
China	70.6	70.4	70	70.2	69.7
Western Europe					
Austria	46.3	44.2	50.2	51.2	50.1
Belgium	n/a	33.1	42.8	42.2	43.6
Denmark	n/a	30.5	35.5	35.9	39.6
Finland	n/a	37.2	61.9	65.4	66.4
France	60.8	35.1	46.6	51.9	47.5
Germany	33.2	38.6	60.8	58.3	60.8
Greece	62.5	52.2	61	65.9	64.2
Iceland	n/a	64.8	73.7	75.4	72
Ireland	49.1	60.6	72	71.1	73.6
Italy	43.6	45.6	52	55.2	54.2
Luxembourg	n/a	51.3	65.7	65.9	62.3
Malta	68.2	64.1	62.2	62.5	63.1
Norway	n/a	57.3	50.8	50.5	52.1
Portugal	60.5	60.4	64	61	61.1
Spain	45.2	45.8	55.3	58.1	53.1
Sweden	44	34.1	33.2	36.7	43
Switzerland	n/a	80.7	73.4	68.2	70.3
The Netherlands	n/a	36.9	48	52	51.8
UK	61.3	62.5	62.3	61.8	62.9
North America					
Canada	64.2	40	75.3	76.7	79.9
USA	64.8	63.8	68.9	67.5	66.2

*Source:* Heritage Foundation website, our elaboration

**Table 3** Government spending – by country (1995–2015)

<i>Government spending</i>	<i>1995</i>	<i>2000</i>	<i>2006</i>	<i>2010</i>	<i>2015</i>
China	93.7	90.3	86	88.1	81.5
Western Europe					
Austria	9.6	25	23.2	28.8	19.8
Belgium	n/a	18.9	26.8	30	10.2
Denmark	n/a	0	9.3	22	1.8
Finland	n/a	0	24.4	32.9	3.6
France	15.7	12.5	11.2	17.9	2.5
Germany	30.6	28	31.7	41.4	40.1
Greece	55.3	54.4	53.9	41.9	0
Iceland	n/a	58.9	32	45.8	32.6
Ireland	38.7	63.3	64.7	61.8	45.6
Italy	3.6	22	29.1	31.2	23.2
Luxembourg	n/a	67.3	36.8	58.5	42.2
Malta	51.8	36.5	35.4	45.6	44.4
Norway	n/a	41.9	34.9	49.8	43.8
Portugal	36	41.9	29.7	37.1	28.8
Spain	36.8	47.1	50.5	54.8	39.8
Sweden	0	0	2.2	17.3	19.2
Switzerland	n/a	28	61.1	68.9	65.1
The Netherlands	n/a	28	29.1	38.4	23.8
UK	37.3	49.6	43.5	41.9	30.3
North America					
Canada	14.8	41.9	53.4	54.1	48.3
USA	57.8	69.3	61.1	58	51.8

*Source:* Heritage Foundation website, our elaboration

## Appendix 2

### *Description of the indices of economic freedom and the global governance indicators*

#### *A Description of the indices of economic freedom*

These indicators, which are published every year, are formulated by The Heritage Foundation (2016), a research and educational institute, founded in 1973, whose mission is to formulate and promote public policies based on the principles of free enterprise, individual freedom and a strong national defence. It is a joint publication of The Heritage Foundation and The Wall Street Journal and it has tracked the progress of economic freedom around the globe, evolving into a data-driven practical policy guidebook that covers many countries encompassing 99% of the world's population. The index of economic freedom documents the positive relationship between economic freedom and a variety of positive social and economic goals. The ideals of economic freedom are strongly associated with healthier societies, cleaner environments, greater per capita wealth, human development, democracy, and poverty elimination. Heritage Foundation defines the 'economic freedom' as "the absence of government coercion or constraint on the production, distribution or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. That is people are free to work, produce, consume and invest in the ways they feel are most productive".

This index measures the degree of economic freedom in 186 countries around the world with a large number of variables that can influence economic development and are divided in ten qualitative and quantitative categories of freedom – from property rights to entrepreneurship:

- 1 property rights
- 2 freedom from corruption
- 3 fiscal freedom
- 4 government spending
- 5 business freedom
- 6 labour freedom
- 7 monetary freedom
- 8 trade freedom
- 9 investment freedom
- 10 financial freedom.

Each of the ten economic freedoms within these categories is scored on a scale of 0 (worst) to 100 (best). A country's overall score is derived by simple averaging these ten economic freedoms, with equal weight being given to each<sup>12</sup>.

The ten economic freedoms are grouped into four broad categories:

- a *rule of law* (property rights, and freedom from corruption)
- b *limited government* (fiscal freedom, and government spending)

- c *regulatory efficiency* (business freedom, labour freedom, and monetary freedom)
- d *open markets* (trade freedom, investment freedom, and financial freedom).

The Index can assume values from 0 to 100, where, in general, high scores are more desirable. In particular, there are five categories of the level of economic freedom:

- 1 free 80–100
- 2 mostly free 70–79.9
- 3 moderately free 60–69.9
- 4 mostly un-free 50–59.9
- 5 repressed 40–49.9.

The index ‘property rights’ measures the will of the government to guarantee the private property and protect it by the expropriation. The index ‘freedom from corruption’ relies on the integrity in the economic system and the freedom from distortion by which individuals or special-interest groups are able to gain at the expense of the whole. This component is derived primarily from Transparency International’s Corruption Perceptions Index (CPI) for 2011, which measures the level of corruption in 183 countries on a scale from 0 (very corrupted government) to 10 (very little corruption), converted on a scale of 0 to 100 by multiplying the CPI score by 10 (i.e., if a country’s raw CPI data score is 5.9, its overall freedom of corruption score is 59). A score of 0 indicated very high level of perceived corruption, while a score of 100 indicates a very little perceived corruption.

The index *fiscal freedom* measures the extent to which government permits individuals and business to keep and manage their income and wealth for their own benefit and use. It includes the marginal tax rates and the year-to-year change in the level of government expenditure regulations often limit the creation of new business. In the index of economic freedom, the burden of these taxes is captured by measuring the overall tax burden from all forms of taxation as a percentage of total GDP.

*Government spending* considers zero government spending as the benchmark, and underdeveloped countries with little government capacity may receive artificially high scores as a result. However, such governments, which can provide few if any public goods, are likely to receive lower scores on some of the other components of economic freedom (such as property rights, financial freedom, and investment freedom) that reflect government effectiveness.

*Business freedom* is an overall indicator of the efficiency of government regulation of business. It is about an individual’s right to establish and run an enterprise without undue interference from the state. The score is based on ten factors, all equally weighted, using data from the World Bank’s Doing Business study [starting a business: procedures (number); time (days); cost (percentage of income per capita); minimum capital (percentage of income per capita); obtaining a license: procedures (number); time (days); cost (percentage of income per capita); closing a business: time (years); cost (percentage of estate); recovery rate (cents on the dollar)].

The *labour freedom* component is a quantitative measure that considers various aspects of the legal and regulatory framework of a country’s labour market, including

regulations concerning minimum wages, laws inhibiting layoffs, severance requirements, and measurable regulatory restraints on hiring and worked hours.

The index *monetary freedom* combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Its score is a number between 0 and 100 and is based on two factors related to the weighted average inflation rate for the most recent three years and price controls.

*Trade freedom* reflects an economy's openness to the flow of goods and services from outside and the citizen's ability to interact freely as buyer or seller in the international marketplace.

*Investment freedom* measures the level of capital flows, foreign investment and analyses the investment climate in a country. This indicator is composed by different variables, that includes the country's investment laws, the treatment of investors and firms, the restrictions on foreign ownership of business, the openness to foreign investors and the government restrictions on capital transactions.

The *financial freedom* variable is a measure of banking efficiency as well as a measure of independence from government control and interference in the financial sector.

### *B Description of the global governance indicators*

Global governance indicators are formulated annually by the World Bank and consist in an update set of worldwide governance indicators, which cover 215 countries. Beginning in the late '90s, the World Bank began to develop and analyse measures for six components of good governance:

- 1 voice and accountability
- 2 political stability and absence of violence/terrorism
- 3 government effectiveness
- 4 regulatory quality
- 5 rule of law
- 6 control of corruption.

In order to give a more widespread comprehension of Chinese governance, we focus on four of these indices, not yet analysed:

- a voice and accountability
- b political stability and absence of violence
- c government effectiveness
- d regulatory quality.

The four aggregate indicators are based on 31 underlying data sources reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide. Different scale of measure may be used for these indices. Here, we reported the values on an 'estimate scale', ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance. In particular, our analysis is based on the values referred to 1996 to 2013 periods.

Moving to consider the single indicators, the first is ‘voice and accountability’: it measures political, civil and human rights. In particular, it reflects the possibility for the citizens to appoint and replace their representatives in elected house of representatives.

The ‘political stability and absence of terrorism/violence’ indicator measures the likelihood of violent threats to governments, including terrorism.

As regards the competence of the bureaucracy and the quality of public services delivery, the ‘government effectiveness’ indicator measures the ability of governments to formulate and enforce credible and coherent policies over time. This indicator includes different variables that regard the public services delivery, the bureaucracy and its independence from the political pressure, the competence of the public employees and so on.

To measure the incidence of market-unfriendly policies, the ‘regulatory quality’ indicator makes a reference to the quality of the policies formulated and enforced by governments. This variable includes some under-indicators that could have a negative incidence on the quality of these policies, such as controls over prices, an inefficient regulation or an inadequate banking supervision.

## Notes

- 1 Studying Chinese law challenges assumptions and expectations about institutional behaviour, European and North American perspectives often assume the centrality of institution in economic and political performance. The China record, however, suggests otherwise.
- 2 Similar evidences may be assumed about the banking sector, largely owned by the state and featured by low capitalisation, solvency and NPLs.
- 3 Established in the 1980s and called the ‘Big Four’ they are the dominant players in China’s banking sector. They are the following: Agricultural Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB) and Industrial and Commercial Bank of China (ICBC).
- 4 They were created in 1994 with state-directed lending role by the government. The policy banks are the following: Agricultural Development Bank of China, China Development Bank and Export-Import Bank of China.
- 5 Some of these institutions have represented an important step for an initial liberalisation process of the Chinese financial system. Commercial banks can be divided into two main groups: Joint-stock commercial banks (JSCBs) and City commercial banks (CCBs).
- 6 Established in the 1980s the main objectives was to diversify the financial system and provide funds through the financing of projects in areas where resources were limited.
- 7 Their role is still limited in China financial system. In particular, since the end of 2006, just before the break up of the financial crisis, banking sector has been completely opened to foreign competition, eliminating geographic, business and currency limitation. This aspect represents an essential step in order to favour competition and the entrance of national and international strategic investors, and to diversify ownership structure in state-owned banks.
- 8 Since their establishment in the 1980s their main objectives have included support for private sector development and financing outside the credit quotas imposed to commercial banks. They were established both by Chinese banks to support a growing market demand for loans on behalf of the rapid economic growth and local governments in raising funds directly, in order to finance local priority projects and obtain higher returns on their investment than through bank deposits.
- 9 The ownership of these institutions is more frequently in the hands of the state, where the focus is on market share. However, in the last few years, new insurance companies are joint-stock companies. Their main objective is focused on economic returns. Since the Chinese

achievements of a full WTO membership, this sector has become more interesting for foreign investors.

- 10 At the beginning of their establishment in 1999, they were seen as independent companies that received NPLs from SOCBs in order to manage and recover them by using several asset recovery methods. The process was aimed at restructuring these capital loans or transform them into equity. In particular the AMCs can borrow from financial institutions in order to achieve their objectives.
- 11 The development of the stock exchanges has been favoured with the establishment of these institutions since the 1990s. Actually, their ownership is diversifying via the participation of the private sector. The leasing companies account for 1% of the banking sector's total assets.
- 12 The index of economic freedom considers every component equally important in achieving the positive benefits of economic freedom. Each freedom is weighted equally in determining country scores. Countries considering economic reforms may find significant opportunities for improving economic performance in those factors in which they score the lowest. These factors may indicate significant binding constraints on economic growth and prosperity.